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An Argument Evaluating Price Controls on Bank Credit Cards in Light of Certain Reemerging Common Law Doctrines

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AN ARGUMENT EVALUATING PRICE CONTROLS ON BANK CREDIT CARDS IN LIGHT OF CERTAIN REEMERGING COMMON LAW DOCTRINES

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> The problem . . . is that the market as it is does not produce a distribution of income and power which satisfies the ideas of modern justice.[1]

INTRODUCTION

In both the historic and current views of the economics profession, price controls are considered almost axiomatically abhorrent as regulatory tools, being at best clumsy and at worst intrusive, disruptive of and distorting to markets.[2] Insofar as public policy considerations are affected, they are widely (though not universally) viewed as harmful—ostensibly for the violence they do to marketplace efficiency. The often implicit and sometimes explicit nostrum is that marketplace efficiency is always to be maximized if public policy is to be optimized.

I would suggest, however, that insofar as the law is concerned, there is nothing intrinsically suspect about such constructs. Indeed, a tenable conceptual basis exists, reflective of actual marketplace functioning, for at least certain types or examples of consumer financial services or products, upon which to reach contrary conclusions. While admitting to numerous difficult and undoubtedly contentious operational issues involved in the implementation of the many possible types of price limitations, these concerns do not irrefutably strip such devices of their legitimacy. I will leave to another time the task of further defining and quantifying both the systemic and targeted costs of

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1. Kenneth Arrow, *quoted in* A. LEVI, JOURNEY AMONG THE ECONOMISTS 104 (1973).

2. This view has predominated for some time, as evidenced, for example, in the collection of somewhat dated but nonetheless illustrative articles found in *Special Project: Usury and the Monetary Control Act of 1980*, 1 ARIZ. ST. L.J. 35 (1981).

so doing. Whether these cost allocations justify or argue against their actual enactment is thus a distinct (through nonetheless important and controversial) question.

I. PRICE CONTROLS GENERALLY

To achieve various objectives of our society throughout history, we have enacted many legal strictures impinging on the otherwise unfettered operation of markets, especially consumer markets. Perhaps the most blunt of such controls are attempts at price controls. We attempt, through both direct and indirect means, to control legally the prices of such diverse items or services as electricity, many types of insurance (including credit-related), natural gas, some forms of housing (e.g., many urban rentals), telecommunications, and food.[3] While not all of these efforts take the form of explicit attempts to directly set prices, they all embody the same goal: namely, to keep prices within predetermined ranges presumably reflecting socio-economic norms of acceptability, while implicitly and simultaneously encouraging sufficient availability of product or service.

Historically, there is no reason to believe that price limits on financial services stemmed from anything other than popularly-based sentiment. No evidence has ever been proffered to indicate that legislators or regulators as a class bear some inherent animus against lenders. Rather, price controls have been founded upon popular sentiment: ideally, of course, the basis for all legislated policy decisions. Accordingly, I hope to identify in the case of one major consumer financial system—the three-party open-end credit system—some of the characteristics that might have contributed to the development of such public sentiment as presumably politically drove the widespread existence of attempts at price controls on that system, and the evolution of various legal doctrines at least in part reflective of such a popularly-held view.[4]

3. Indeed, the case can be made that as a matter of promoting various goals of "public policy," we systematically and consciously attempt to influence strongly, if not explicitly control, the general level of interest rates—the subject of this article—through the specific and intentional operations of the Federal Reserve System in guiding monetary policy.

4. I also willingly and cheerfully admit that cases of similar intellectual coherency do not universally exist regarding all consumer financial services or products. As I admit to the possible optimality of relatively unfettered market operation for *some* particular products or services, so too would I hope that the theological opponents of

I would then comment on certain aspects of more traditional, explicit, legal controls such as fixed or floating ceilings and price caps, and on the potential application of more subjective, less quantitative, emerging, or, in some case, reemerging, legal/sociological concepts, such as unconscionability and good faith.

II. Open-End Credit

Open-end credit originated as an ancillary service offered by merchants to assist in the promotion of the sale of merchandise or non-financial services. Any additional nonrecoverable costs created by such a promotional aid ought, in an ideal world, be borne by those consumers benefitting therefrom—the users. Simple concepts of fairness suggest that cash-paying customers ought not to "pay" for such props in the form of higher prices.[5]

This unremarkable notion was in the real world especially compelling to merchants because cash-paying customers, often being those with the highest disposable income, were typically the most economically desirable customers, and those whom merchants were most anxious not to offend or lose through adverse cost-shifting. Yet, charging interest rates allegedly necessary to make such services economically self-supporting often involved imposing rates offensive to broadly-based societal notions of acceptable levels of usury. Whether subjective or not, such objections were, and are, nonetheless real.

A. *Conceptual Objections to Price Caps*

Price limitations on credit services have not been imposed without resistance. They have been attacked for years[6] on several principal theoretical grounds:

legal price controls would also avoid inflexibly dogmatic postures opposing even the concept of such controls.

5. This straightforward notion admittedly ignores the potentially complicating concept that cash-paying customers might benefit indirectly from the availability of credit services insofar as greater volumes of sales are engendered, thereby allowing economies of scale which in turn could reduce marginal unit costs. While this offset theoretically exists, it is almost certainly not meaningfully present in many if not most retail purchase situations. In addition, its impact will almost certainly disappear insofar as the card-issuing institution is concerned in any three-party system. See *infra* note 6 and accompanying text.

6. *See generally*, Kawaja, *The Economic Effects of Regulation*, 35 S. ECON. J. 231 (1969), and its numerous progeny.

> a. Overly restrictive price limits will limit the aggregate amount of credit available;
> b. Any such limitations on availability will fall disproportionately on the less economically advantaged; and
> c. Such limits create distortions or subsidies (which presumptively are inherently 'unfair') as between consumers purchasing by cash or credit because creditors are unable to recapture completely the costs of providing credit in its explicit price.[7]

It is instructive to examine each of these arguments as they might apply to the example of three-party credit cards (hereinafter 'bank cards').[8]

1. Availability

Is there any meaningful basis for concern regarding the availability of bank card credit? During the 1980s, open-end credit grew faster than any type of consumer credit. From 1979 to December of 1989, total open-end credit from all providers,[9] the vast majority of which is extended by means of credit cards, grew from 17.78% to 28.35% of total outstanding non-mortgage consumer credit.[10] Only a small portion of this increase can be attributed to new institutional sources, viz., thrift institutions.[11]

The growth in the same period of such credit extended by commercial banks was extraordinary and virtually unprecedented—from 9.31% to 17.07% of the total.[12] In fact, just

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7. To the extent that finance charge revenues received are inadequate to cover costs incurred in so providing, purveyors must, presumably, either accept lowered overall profitability or recover some portion of such uncompensated costs from other customers not incurring explicit credit-related charges. For purposes of this discussion, I assume that any cost savings induced by economies of scale realized through increases in sales volumes are insufficient to recoup such costs. While this may or may not be true in a two-party, merchant-customer environment, it seemingly must be the case in the three-party, merchant-issuer-consumer world of the bank card system, at least insofar as the card issuer, the party subject to any interest rate controls, is concerned.

8. The focus here is on credit extended most typically in the United States through the VISA, Mastercard and Discover systems, although several smaller systems also provide such three-party (cardholder, card issuer, and merchant) credit.

9. Includes both depository institutions and retailers, most typically department stores, gasoline companies, airlines, etc.

10. FED. RESERVE BULL., tbl. 1.57; p. A42, Mar. 1980; p. A39, Apr. 1990.

11. Even by 1989, savings institutions and credit unions combined comprised less than eight percent of total open-end consumer credit outstanding.

12. *See* FED. RESERVE BULL., *supra* note 10.

the *growth* in the absolute amount of such credit extended by commercial banks, the bulk of it via bank cards, during that period was almost twice as much as the *total* amount of open-end credit outstanding as offered by retailers, savings institutions and credit unions *combined* at the end of the period![13]

Obviously, aggregate credit extended by means of credit cards increased enormously during the 1980s, with the bulk of the increase coming from commercial bank issuers. Clearly, this was a popular, widely-accepted, and presumably a relatively widely available form of financial service.

Considering only aggregate extensions, it could be argued that this phenomenon was primarily due to relaxation of interest rate controls in several jurisdictions during this period. After all, many issuers have relocated operations to states from which they are permitted to "export" any rate permitted by the laws of the state where located, as per *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*[14] However, programs in many states where rate controls have remained in effect also have exhibited comparable, substantial rises in availability, as measured by total outstandings.[15]

Proponents of rate deregulation have regularly argued before both federal and state legislative and regulatory bodies that lenders will not charge significantly higher rates in a rate deregulated environment, ostensibly due to the forces of price competition. If that is the case, and in the absence of additional explanatory factors, it would then be internally inconsistent to argue that the enormous growth in open-end credit is limited to only those states which have chosen *not* to retain rate limitations.

Bank card credit has grown dramatically because first, it is extraordinarily profitable,[16] thereby attracting numerous vendors, often with nontraditional, attenuated pedigrees as

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13. *Id.*
14. 439 U.S. 239 (1978).
15. For example, one large issuer in Wisconsin, a state which has consistently refused to repeal existing usury ceilings applicable to bank card credit, saw its bank card outstandings increase by 149% from 1979 to December, 1990. Telephone Interview with H. Weller, Firstar Bank-Milwaukee (then, First Wisconsin National Bank of Milwaukee) (Apr. 17, 1991). This actually *exceeded* the increase in commercial bank revolving outstandings nationally (the bulk of which, recall, is via credit cards), which was 113% from December 1979 to November 1990, FEDERAL RESERVE BULLETIN.
16. *See infra*, Section II-B-1.

lenders.[17] Second, consumers gain real value from such a product. I would characterize the differences in the degrees of such increases in regulated and unregulated states as "enormous" versus merely "huge." The pertinent point for this analysis then seems to be that even in many regulated states, the growth, and hence, the availability of open-end credit has been substantial.

Further, with some card issuers now routinely soliciting bank card accounts from such credit risks as undergraduates as low as the freshman level, there are few who would or indeed can credibly argue that numerous deserving card applicants are unable to obtain bank card credit. The allegation that open-end credit would not widely be available in the absence of such rate deregulation as occurred in the 1980s remains unproven.[18]

2. *Rationing out the Low-Income*

The second major criticism of price controls on open-end credit centers on the contention that such controls will effectively prevent extensions of credit to higher-risk consumers, which many refer to as the less economically advantaged, though the overlap between these two categories is by no means necessarily congruent. It is pertinent to examine the historical context. Various and numerous proposals for consumer credit regulatory controls historically have been resisted with charges that low-income consumers will, as a result, be shut out of markets. In many cases, these predictions have largely failed to materialize.[19]

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17. For example, recent entries into the bank card arena include such prominent and deep-pocketed institutions as AT&T, General Motors, General Electric and Ford Motor Company, all of which have gained some lending experience previously with consumers, but only as a means for enhancing sales of their primary products or services.

18. Note also that the very argument that any impingements upon aggregate availability are undesirable presumes, rather than establishes, *as a matter of public policy* a position that is at least open to question and challenge.

19. See generally the discussion, beginning at page 489 in the Federal Trade Commission Staff report on the Proposed Trade Regulation Rule 16 C.F.R. pt. 444, PUB. REC. 215-42 (1980). See also the first Annual Report to the Governor and Legislature on the Wisconsin Consumer [Credit] Act, Mar. 1, 1973—Feb. 28, 1974, submitted by the Office of the Commissioner of Banking, State of Wisconsin:

> The enactment of the Consumer Act was accompanied by forecasts that it would precipitate the end of consumer credit in this State. This has not been the case. During the first year under the Act, the consumer credit industry has remained healthy and we can find no evidence of a restriction in the extension of consumer credit due to the limitations of

Indeed, it strains credulity to suggest that the aggregate proliferation of consumer credit *across virtually all socio-economic strata* generally over the past two decades in which literally hundreds of various regulatory "burdens" have been enacted could have been as expansive and unprecedented in scope were the alleged "rationing" argument against the poor so compelling.

It is certainly not suggested that there have never been instances in which regulatory impingements on market functioning have precipitated creditors to tighten underwriting standards and thereby reduce credit availability to higher-risk consumers. What is challenged, however, is the notion of some intrinsic relationship between the imposition of regulatory "burdens" on creditors and an allegedly inevitably disproportionate impact on low-income persons.

Further, this particular criticism of usury ceilings is founded upon the unspoken assumption that government acting in a manner which might potentially deny some consumers access to a particular product or service is *per se* undesirable, regardless of either the magnitude of the group denied or of the possibility of countervailing advantages or benefits realized by other, potentially significantly larger, groups of consumers. The proposition that government should not act in a manner which may deny some group access to some product is, as a matter of public policy, neither uniformly accepted nor patently obvious. Also interesting is the tacit admission in such an argument that this question *is* appropriately a matter of concern regarding public policy formation, a proposition vigorously denied by some economist proponents of rate deregulation.

Consider that: 1) carefully drawn usury ceilings can undoubtedly protect against profiteering; and, 2) the level of penetration of card issuance into the public as a whole is enormous. Accordingly, it seems at least possible that significantly more consumers may well be benefitted by limitations on interest paid than would be harmed, even assuming the ceilings act as an effective barrier to obtaining credit. Whether this is in fact the case is the subject for further analysis and debate. The pertinent point here is that it is, *as a*

> the Act. The dollar amount of consumer credit outstanding, continues to increase.

Id.; see also, Thomas D. Crandall, *Wisconsin Consumer Credit Laws Before and After the Consumer Act,* 1973 WIS. L. REV. 334 (1973).

matter of public policy formation, a clearly defensible and reasonable position to take and for which to advocate.

Evaluating such competing interests necessarily involves invoking and making value judgments, and as such, is not always likely to lead to a clear-cut and universally accepted answer. It is also an exercise in which economists are not typically enthusiastic participants. But the law, especially consumer protection law, involves assessment and evaluation of such divergent interests on a regular and predictable basis. Why is *this* type of consumer protection balancing test inherently suspect when others seemingly are not?

Based on the experience in many states, it is not altogether clear that carefully drawn usury ceilings will necessarily adversely restrict the availability of open-end credit to identifiable groups of consumers. Even if that were the case, however, for the purposes of setting public policy, whether the "harm" suffered by such consumers is or is not offset by any "benefits" reaped by others is a question involving the weighing of competing interests, a question typically and clearly appropriate for policymakers. Where is it decreed, after all, that limiting access to credit of a relatively few, presumably higher-risk borrowers is *per se* objectionable?

Finally, additional societal "benefits" from lower open-end credit rates have been alleged beyond simply fewer interest dollars paid by cardholders. A recent study contends that the United States economy *generally*, as contrasted with only cardholding consumers, would benefit significantly from reductions in credit card rates.[20] Is it somehow impermissible for policymakers to seek to achieve *these* purported benefits *through the mechanism of usury ceilings*? The point here is not whether usury ceilings represent the optimal way in which to attempt to realize any such purported benefits; rather, should policymakers be precluded from even considering them as a potential means for achieving the presumed benefits because doing so may allegedly impinge on some group's supposed access to a particular product or service?

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20. *See*, Sinai, *Debt, Credit Card Borrowing and the Economy*, Prepared by the Boston Company Economic Advisors, Inc. for American Express Travel Related Services Company, Inc., May, 1992.

3. Cross-Subsidies

Additionally, rate ceilings have been attacked as preventing creditors from considering risks inherent in credit and thereby creating subsidies as among borrowers. While the contention that subsidies exist within consumer credit systems may well be to some extent true, for this to be a fair criticism of rate ceilings, the real question is whether the relaxation or removal of rate ceilings would *alleviate* this supposed unfairness. Since it is not solely or necessarily even primarily the operation of rate ceilings which create cross-subsidies in the first place, such a criticism may well be subject to refutation if the purported remedy—rate deregulation—fails to ameliorate the complained-of condition. The issue is whether rate ceilings exacerbate inherent subsidies in a way which is deemed inimical to public policy.

Because consumer credit systems involve transactions of relatively small size, it would in many such systems be intrinsically uneconomical for a creditor to evaluate risks individually and allocate presumably varying degrees of risk among individual borrowers through distinctive rates for transactions beneath some given size. Of all consumer credit systems, this "customization" of interest rates seems least likely for bank card systems since the typical account balance is the among the smallest of all the most common forms of consumer credit.[21] Thus, borrowers of differing underlying "riskiness" structurally pay equivalent, nominal rates to the same creditor, thereby "subsidizing" or "being subsidized by" one another. A lower-risk borrower and a higher-risk borrower, each of whom qualifies under a given creditor's credit standards, will typically pay the same rate.[22]

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21. In fact, even in mortgage residential lending, the largest typical example of consumer credit, uniformity of rates among qualifying applicants is the norm, with only limited exceptions.

22. There has been some, relatively minimal segmentation of rates occurring in 1992, among a few selected card programs. However, these have typically been of the form where a narrowly defined subset of an issuer's portfolio has been assigned a nominally lower rate. For example, a program might allow a lower rate to those cardholders who had borrowed more than a specific amount in the previous year and had never missed a due payment in that period. However, even some of those changes have been criticized for actually lowering effective rates much less than implied in associated advertising campaigns by, for example, designing the qualifying characteristics for receiving the lower rate in such a manner as to include primarily those borrowers who are consistently 'convenience' users, thereby rendering the purported interest rate reduction largely ephemeral. For example, "Citicorp's 'lowering'

To the extent rates rise when rate ceilings are removed,[23] how would these higher rates be expected to lead to more individually-tailored, and thereby, less "cross-subsidized," rates, easing, as such, any inherent cross-subsidies? Given the unattractive economics of making individual risk assessments for such relatively nominal amounts, one would seemingly still expect such cross-subsidies, albeit at now higher rate levels. Such a result could then predictably be expected to evoke less than an enthusiastic response among consumers and their advocates.

B. *Market Characteristics and Consumer Benefits*

Seemingly, neither the degree nor the demographic distribution of availability are then major problems which rate deregulation might serve to mitigate meaningfully. But, this in itself may not be sufficient to justify price controls. Are there benefits that might be expected from such limitations?

Benefits might stem from the fact that price competition seemingly does not operate effectively to restrain interest rate charges in national credit card markets, and as a result, consumers in the aggregate pay significantly more than is apparently necessary for such services. As support for such an assertion, I would offer the following.

1. *Price Competition as a Restraining Influence*

The profitability of the bank card industry is virtually unparalleled among various consumer financial services. Profitability of bank card systems net of allocated overhead is conservatively (and has been consistently for about ten years) on the order of thirty-five to forty dollars per $1000 outstanding.[24] Credit card lending is, and has been consistently throughout the 1980s, the single most profitable consumer financial service offered by depository institutions.[25] In fact, aggregate credit

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of credit card interest rates was a marketing coup . . . . But at least in terms of Citicorp's bottom line . . . there will be virtually no cost, as confirmed by a Citicorp insider. The reason is that very few Citicorp cardholders actually will benefit from the lower rates." *Lower Rates or Brilliant Hype?*, 8 U.S. BANKER, June 1992, at 8.

23. One can only assume they would—why else would the creditor community have worked so long and diligently in its efforts to remove them?

24. *See, e.g.*, P. Lucas, *What's Ahead for Bank Card Profits?* 3 *Credit Card Management* 12, at 32 (1991).

25. Functional Cost Analysis, Federal Reserve System, *National Average*

card lending is even more profitable than has been officially reported by the Federal Reserve System.[26] Sustainable nominal interest rates averaging eighteen percent per annum have been characterized by publications normally friendly to and uncritical of lending interests as "incredibl[e]."[27] "The card business is a bonanza."[28] By economic theory, such returns could not persist at such elevated levels in the presence of significant and effective price competition.

Second, if price competition were actually present, one would expect some significant degree of advertising of price advantages by major providers in an effort to attract market share in such an enormously profitable market. None of the major bank card issuers has aggressively and protractedly engaged in a marketing campaign to attract customers in which a preferable annual percentage rate has been stressed.[29] While some issuers have attempted to enter the bank card market with significantly lower interest rates, these have typically been in the form of so-called "teaser" rates, i.e., a significantly lower rate is offered to attract cardholders, but only for a limited period, after which rates return to the industry norm.[30] These attempts presumably reflect a recognition by sophisticated marketers that lowering rates does not work effectively either to attract market share or increase overall profitability.

Commercial Bank Report, annual data.

26. The Federal Reserve System's Functional Cost Analysis (FCA) is drawn from voluntarily-provided information furnished by member banks. The data actually obtained includes only those provided by relatively small issuers. It does not typically include data from the largest issuers. And, because of economies of scale as among issuers, these large issuers (all other things being equal) can be expected to realize greater profitability than those smaller institutions reporting on the FCA, *Perspectives*, Federal Reserve Bank of Chicago, Mar.-Apr. 1987, 11.

27. *Business Week*, Sept. 21, 1992, at 76.

28. *Id.*, quoting T. Hanley, First Boston Corporation.

29. A number of major issuers have sought to compete on the basis of price insofar as periodic (typically, annual) fees associated with cards are concerned. The relative marketing sophistication of such issuers, combined with the extensive consumer research and testing they have historically performed, suggests that they have concluded that price competition in periodic fees is significantly more effective as a competitive tool than are annual percentage rates. *See infra* note 31.

30. For example, GTE, a major telecommunications provider announced a new combination credit card/telephone calling card with an ostensible six percent Annual Percentage Rate (APR). *USA Today*, Sept. 24, 1992, p. 1. Upon closer examination, however, it was revealed that this admittedly "low" rate was applicable only until April, 1993, when it would revert to a floating rate, comprised of the announced "Prime" rate *plus* 10.6 points. At current rates, that would provide for a 16.6% APR.

Third, if price competition as among interest rates were actually functioning even somewhat effectively, one would expect to see the general level of bank card interest rates to have fallen and risen somewhat in line with the general level of the cost of funds used to fund such programs during the 1980s. Examination of Federal Reserve statistics on the average interest rate charged on bank card programs during that decade shows that the rate charged remained virtually constant and even rose slightly, notwithstanding substantial increases and declines in the underlying cost of funds during the decade.[31]

In contrast, price competition as among noninterest terms seems to be perceived by issuers as much more effective in attracting consumers. For example, AT&T Corporation has been enormously successful in attracting customers to its new Universal Card with a marketing campaign promising to forego any annual fee forever for customers enrolling before a certain date.[32] On the other hand, price competition as among interest rates seemingly is not being widely utilized or is not operating effectively to restrain prices.

2. *Potential Benefits*

Might a modest reduction in nominal interest rates charged in the bank card system result in significant benefits to consumers? A decline of only two percentage points in the nominal rate applied to the outstandings of the two major bank card systems in the United States alone would, even assuming no increases in activity with such a lowered cost and no improvement in loss experience (both or either of which could be expected to improve further the profitability of such plans), result in aggregate

31. Recent research confirms the relative "stickiness" of bank card interest rates, at least as compared with other non-mortgage consumer loan rates. "The stickiest movement among loan rates is the credit card rate . . . ." Donald G. Simonson, *Taking Advantage of Consumer Naivete*, U.S. BANKER, Apr. 1991, at 52, 54, reporting on research by Professor Lawrence Ausubel, Kellogg Graduate School of Management, Northwestern University. Equally on point is the related finding that "[t]he implication is that the accounts whose rates are most controllable are also the most profitable." *Id.*

32. This suggests that while consumers are relatively insensitive to savings of two to three dollars per month which might result from a three percent drop in APR on a $1000 balance, they seemingly are much more receptive to saving twenty to twenty-five dollars in annual fees collected in one, presumably more visible, installment, even though the aggregate savings from a lowered APR are greater. While fascinating, that particular exhibition of consumer behavior is the topic for another article.

savings to consumers well in excess of at least two billion dollars per year.[33] Such a potential benefit seems, by any imaginable standard, substantial.

Other benefits, both quantifiable and otherwise, might well also accrue from reduced interest rates on credit cards. One recent study suggested that the same two percentage point decline in credit card rates during the past two years would have increased personal savings by $2.9 billion, increased sales of goods and services by $4.1 billion, increased sales tax revenues by $250 million and created almost 16,000 jobs.[34] Whether the quoted numbers are exact or not does not detract from the potentially enormous aggregated societal benefits from reduced interest rates.

Additionally, more subjective benefits may also accrue from a carefully designed rate ceiling in the form of an amelioration of the uneven impacts of current pricing regimens. For example, as one might suspect intuitively, higher-income or higher-net worth consumers are more likely to be so-called "convenience users," paying their balances in full within the typically allowed grace period and incurring no finance charge. Middle-income consumers,in contrast, are more likely to revolve a balance and thus pay a finance charge thereon; or, put another way, they are likely to pay more finance charge per dollar of sales volume than do upper-income cardholders.[35] The payment of finance charge is then, as one might expect, noticeably regressive with respect to income.[36]

This phenomenon is compelling in view of the disparate likely impacts of usury ceiling elimination. A convenience user is

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33. Calculated based on commercial bank revolving credit outstandings in the United States as of December, 1989, of $131 billion, FED. RESERVE BULL., Sept. 1990, tbl. 1.55, p. A39.

34. Sinai, *Debt, Credit Card Borrowing and the Economy,* Prepared by the Boston Company Economic Advisors, Inc. for American Express Travel Related Services Company, Inc., May, 1992.

35. It is necessary to examine finance charges relative to the sales volume incurred, given the obvious capacity of higher-income cardholders to spend a greater absolute number of dollars in comparable time periods.

36. "Among customers with credit cards, it is the highest income customers who are most likely to pay off their balances during the free period." BAXTER ET AL., RETAIL BANKING IN THE ELECTRONIC AGE, 40-41 (1977). This characteristic was recognized relatively early on in the development of the credit card industry. *See, e.g.*, MANDELL, CREDIT CARD USE IN THE U.S. (1972); SHAY & DUNKELBERG, RETAIL STORE CREDIT CARD USE, 51 (1975).

essentially impervious to increases in nominal rate, while a revolver obviously faces varying charges, absent changes in personal behavior. To the extent higher rates follow ceiling relaxation or elimination, the bifurcated impacts mentioned above are exacerbated.[37]

Examination of the market suggests that not only is price competition not operating effectively to restrain and depress interest rates, but further, more moderate income consumers are paying what appears to be a disproportionate share of total finance charges. Under such circumstances, the policy basis for considering price limitations, notwithstanding any violence done to market "efficiencies," seemingly is established.

Nonetheless, there remain enormous complexities in attempting to design such a control or system of controls so as to attempt to mitigate the market deficiencies described above, while limiting the disruptive impacts of controls to market functioning and the economic efficiency which is otherwise sought to be maximized.

3. *The Example of Additional Charges*

Price controls can become quite complicated in the case of open-end credit, not only because of the manner in which finance charges are typically calculated and assessed, but also because of the complex menu of additional charges and price-related features usually associated with such plans. Roughly thirty percent of total revenues received by card issuers are derived from sources other than explicit payment of finance charge, such as periodic fees, interchange fees received, merchant discount income and the like.[38] Accordingly, in attempting to control or distribute total costs paid by consumers, it may be insufficient simply to impose a ceiling, either fixed or floating, on finance

37. To attempt to address this uneven impact, it seemingly would be more even-handed to impose the nominal finance charge from the date of the transaction on all transactions rather than to increase the nominal rate and retain the grace period. (Most significant card programs already do this when balances are revolved as well as for all cash advances; hence, the operational difficulties in implementing such a policy are presumably not insurmountable.) Applying a nominal rate from the date of all transactions would also enable an issuer to achieve its desired yield with a significantly lower nominal rate, since all advances would now accrue interest charges.

38. Proprietary systemic data from a major bank card system in the possession of the author.

charges. Other revenue sources to issuers would likely need to be assessed and provided for in any effort to distribute systemic costs differently.

This effort creates its own set of complications. For example, consider the case of late charges. Bank card contracts generally specifically provide flexibility to the cardholder in establishing the amount of the payment, down to some specified minimum amount, typically the lesser of a fraction of the total outstanding or a fixed *de minimis* amount, say ten dollars. However, when a payment of less than that minimum is made (or, more frequently, no payment at all), virtually all agreements provide for the imposition of a late charge.

Several arguments have been advanced historically in support of: 1) the economic justifications of such charges; and 2) their exclusion from the definition of finance charges (with their resultant exclusion from any rate ceiling calculations). An examination of several of these notions is illustrative to the evolving legal context in which rate ceilings might thusly be considered.

A. They have been endorsed as economic incentives for prompt payment, or, in mirror image, as a "penalty" for late payment. Late payment is viewed at the time of contract formation as a contingent event and thereby properly excludable from finance charge. To the extent that such a charge would be treated as interest, the borrower could in effect unilaterally convert an otherwise legal contract into a usurious one.[39]

B. Late fees have also been characterized as compensation to creditors for added definable expenses incurred when delinquent payments are received or when scheduled payments are not made. Many legislatures have implicitly endorsed such a justification through formulations limiting such fees in amount, thereby recognizing the various relatively mechanical actions which a creditor might routinely take when a scheduled payment is not received, for instance, a followup "reminder" letter.[40]

39. *See,* Camilla Cotton Oil Co. v. Spencer Kellogg & Sons, Inc., 257 F.2d 162 (5th Cir. 1958).

40. *See, e.g.,* U.C.C. § 2.203 (1969); Wis. Stat. § 422.203(1). Note that specific exclusions from the statutory definition of "finance charge" are also often necessary to avoid usury problems.

Presumably, the certainty of such a formulation would be attractive to issuers in that arguments as to the reasonableness of the relationship between the amount of the charge and the "cost" which it is intended to compensate could be avoided.[41] Any amount charged as specified in the regulatory framework would be permissible and any additional amount would presumably be interest.

C. Some states (such as California) have characterized late fees as liquidated damages.[42] A late payment is defined prospectively by the parties as constituting a breach of the contract, with damages resultant from such breach. Thus, a late fee which represents a good faith effort on the part of the parties to determine the amount of such damage would be unassailable as a measure of liquidated damages.

4. Assessing Costs

By definition, this kind of analysis involves estimation of the "costs" created for the lender in such an event. This estimate follows from the foregoing analysis since the amount of the late charge ought to bear a reasonable relationship to the purported damages actually suffered by the lender as a result of the failure to pay as promised. To the extent that the charge *exceeds* the amount reasonably due as compensation to the injured party and serves as a penalty for the delinquency, such an excess charge would presumably not be defensible as a measure of liquidated damages.[43]

The effort involved, and presumably the "costs" of making defensible estimates of these types of damages *qua* costs have often been assailed and as a result, legal theories entailing such tests have been vigorously criticized, again, as a matter of public policy. "There are enormous difficulties and questions of judgment in determining cost, especially in a service industry. This becomes a cost of doing business that must ultimately be borne by the consumers."[44] There seems to be no small irony in

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41. See the discussion of the *Perdue* criteria regarding the relationship between the charge actually imposed and the costs underlying such charge, *infra*, beginning at p. 814.

42. Garrett v. Coast and So. Federal S&L, 511 P.2d 1197 (Cal. App. 1973).

43. *See, In re* Hein, 60 B.R. 769 (Bankr. S.D. Cal. 1986) (wherein a late fee of $500 per day was held to be an unenforceable penalty).

44. William Alsup & Lawrence Lincoln, *A Management Strategy Under Perdue,* 42

such a generalized industry objection to exercises in costing various aspects of services offered. Usury ceilings have been widely attacked by lenders because of their alleged interferences with creditors' abilities to charge prices for services "commensurate with their costs."[45]

To refuse to require any connection or relationship between the damage done to the lender as a result of the borrower's breach and the amount payable by the borrower as a result thereby undercuts the entire analysis of late charges as a measure of liquidated damages. As the *Perdue*[46] analysis suggests, it may well be that undertaking such effort is necessary, notwithstanding the "costs" to the purveyor of so doing, at least in some states. Courts are beginning affirmatively to assert this view; in California, liquidated damages provisions in consumer contracts are void unless it is "impracticable or extremely difficult to fix the actual damage [for a breach] and the bank had made a 'reasonable endeavor' to estimate a 'fair average compensation' for its loss."[47]

5. *Other Considerations*

With respect to the regulation of nominal interest rates, a number of questions are raised. A fixed ceiling, of course, has the major advantage of being specific and certain. While questions may exist as to whether particular charges or fees legally are interest, it is nonetheless relatively easy for a lender to determine with great certainty its compliance or lack thereof. Fixed ceilings, equally obviously, have the potential disadvantage of being set either too high so as to be ineffective or too low, thereby truly inhibiting market functioning by choking off credit availability inappropriately.

Floating ceilings have the conceptual appeal of being able to reflect increases or decreases in underlying costs of funds. Operationally, however, they entail additional and often difficult

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BUS. LAW. 893, 898 (1987); *see also*, Brown's Law No. 1 of Consumer Affairs: "The consumer always pays; the only really interesting question is who gets to give him the news." *Id.* (citation omitted).

45. "Unique to the financial industry, there is no assurance that increasingly dynamic costs will be recovered since usury ceilings limit the creditor's ability to balance product price with product cost." Schellie, 7 *A Rational Response to State Price Controls on Credit,* (Sept. 1980) prepared for the American Bankers Association.

46. Perdue v. Crocker Nat'l Bank, 702 P.2d 503 (Cal. Ct. App. 1985).

47. Beasley v. Wells Fargo Bank, 1 Cal.Rptr. 2d 446,448 (Cal. Ct. App. 1991).

questions involving such issues as how rates are adjusted, how and when notices thereof are provided to borrowers, and what rates apply to outstanding balances.

It is not my intent here to discuss the particulars of such a proposed ceiling. Rather, the purpose is to address briefly a few relatively hoary legal doctrines which have been (depending on one's point of view) either evolving or reemerging in the last few years. Specifically, they will be analyzed as they might relate to certain aspects of bank card credit.

III. (RE)EMERGING DOCTRINES—*PERDUE* ET AL.

The *Perdue* case represents an important milestone in the history of efforts to regulate the price of financial services through legal means. *Perdue* stands for the proposition that, while an allegation that price exceeds cost or fair value does not standing alone state a cause of action that the price term of the contract is *per se* unconscionable, nonetheless, such an allegation may support an inquiry in the "setting, purpose and effect" of a particular pricing practice; and, further, by clear implication, such an inquiry presumably might ultimately lead to a finding of unconscionability.

In evaluating such a claim, the California Supreme Court in *Perdue* held that an inquiry could examine the market price of the service, its cost to the seller, any inconvenience imposed upon the seller, the true value of the service, the absence of meaningful choice, any lack of sophistication of the buyer, and the presence of any deceptive practices. Although *Perdue* involved charges for NSF checks, it was founded upon a statute[48] interpreted to apply in all commercial contexts.

The *Perdue* court rejected the defendant bank's contention that a price could not be found unconscionable as a matter of law if it was in line with market prices for such services. Rather, it offered that while "it is unlikely that a court would find a price set by a freely competitive market to be unconscionable, the market price set by an oligopoly should not be immune from scrutiny."[49]

48. CAL. CIVIL CODE § 1670.5 (West 1987).
49. *Perdue*, 702 P.2d at 511.

A. Changing Account Terms

In open-end credit, consideration of a floating rate ceiling necessarily involves treatment of outstanding balances. When a rate is adjusted to a level which, while it can be provided for contingently, cannot be specified with certainty, what balances, if any, will be subject to the new rate and what to the old? The *Perdue* analysis is potentially pertinent in light of its extensive focus on the ability of one party to change the terms of the agreement.

In *Perdue*, the plaintiff-consumer argued that the allegation that the consumer could be inferred to have given assent to subsequent changes in prices by virtue of not having canceled was found to be illusory.[50] The court rejected such a conclusion where the actual exercise of the power to set or adjust charges was reasonable. It did, however, indicate that the bank was subject to a duty of good faith and fair dealing in "setting or varying charges."[51] This strongly suggests that open-end rates pegged to market rates might bear up better under such scrutiny than would rates adjustable at the whim of the issuer.

The consumer in *Perdue* further argued that a signature card was a contract of adhesion. Under California law, such a contract is nonetheless enforceable unless: 1) the provision is not within the reasonable expectations of the weaker contracting party; or 2) the provision is unduly oppressive or unconscionable. In determining the latter, a claim could presumably engender an inquiry into the "setting, purpose, or effect" of such a contractual provision.[52]

B. Bank Card Market Characteristics

The possible application of such notions to bank card pricing is intriguing. If, as argued above, open-end credit is not, insofar as rate is concerned, operating in a price competitive market, if the price charged substantially exceeds the cost to provide (as

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50. *Id.* To the extent that higher rates are imposed only upon new balances incurred after some appropriate notice to the consumer, this difficulty is largely ameliorated, as the consumer presumably has affirmatively elected to accept such higher charge following notice thereof, as evidenced by an affirmative election to obtain another advance on the credit line. *See, e.g.*, WIS. STAT. § 422.201(10m)(h) (1983).

51. *Perdue*, 702 P.2d at 510.

52. *Id.*

evidenced, for example, by protracted and unusual profitability), and if the pricing structure of such a mechanism is regressive, the *Perdue* analysis suggests that an inquiry might quite properly then be had into the "setting, purpose or effect" of such pricing provisions.

C. Establishing Account Terms

Another interesting case is *Best v. United States National Bank of Oregon.*[53] In that case, the plaintiffs challenged nonsufficient funds (NSF) charges on several grounds, including application of illegal penalties, alleged breach of a duty of good faith, and unconscionability. On the penalty argument, the court held that the absence of any agreement between the depositors and the bank wherein the depositors agreed not to write NSF checks precluded a finding that the charge could be a penalty for breach of such an agreement as prohibited by section 1.106 of the Uniform Commercial Code.[54]

Nonetheless, the court held that in setting such a fee the bank was constrained by a duty to exercise good faith. The court further held that it might be a basis for depositors to recover for breach of covenant if there was evidence that the charge greatly exceeded the costs of processing the checks and that the profit derived therefrom exceeded the bank's normal profit margin.[55] In considering the open-end credit system, the virtually unparalleled, persistent profitability of the bank card system at least suggests that the level of charges for such a program might be subject to review under the *Best* criteria.

The *Best* court distinguished the doctrines of good faith and unconscionability. It noted that unconscionability is a doctrine which can typically only be asserted defensively, or in other words, "not [as] a basis for affirmative relief."[56] However, this circumstance seemingly might arise when changes in account terms are implemented by issuing institutions. The impact to consumers is significant, for as explicitly noted in *Perdue*, "[s]mall charges applied to a large volume of transactions [as in,

53. 714 P.2d 1049 (1986).
54. *Id.* at 1054.
55. *Id.* The opinion did not address the notion of whether "normal profit margins" might differ across varying distinct products. *Id.*
56. *Best*, 714 P.2d at 1051.

for example, a large bank card program?] may yield a sizeable sum."[57]

Good faith, however, is implicitly a duty in every covenant, together with a duty for fair dealing, and can be affirmatively asserted by the nonbreaching party. Thus, whether an issuer's behavior constitutes a breach of those duties raises potentially justiciable questions of fact.

A subsequent case in Oregon expanded on this line of reasoning. In *Tolbert v. First National Bank of Oregon,*[58] the Oregon Court of Appeals explicitly extended the good faith obligation as well as the principle of reasonable expectations to revision of charges upward after the opening of the account. The *Tolbert* case distinguished *Best*: in *Tolbert*, the bank had specifically notified the customer of the existence of an explicit charge upon opening the account, whereas in *Best*, the agreement (the signature card) merely indicated that the account was subject to the bank's usual rules and regulations, a copy of which was not routinely provided to each customer.[59]

The *Tolbert* court interpreted *Best* to mean that the obligation of good faith derives primarily from the bank's unilateral ability to fix charges after the parties reached their original agreement, i.e., to change them.[60] Specifically, the bank did not satisfy such an obligation simply by notifying customers about such an increase and permitting them to terminate the account without penalty after receiving notice. This performance presumably did not rise to the level of a "reasonable" exercise of the duty of good faith.[61]

Whether increases are consistent with the obligation of good faith and with the customer's reasonable expectations may give rise to issues of material fact. Applying the *Best* criteria, changes in open-end plan terms might be reviewable based upon the margin by which charges exceed costs, and any resultant unusual profitability enjoyed under an open-end plan.

57. *Perdue,* 702 P.2d at 513.
58. 772 P.2d 1373 (1987).
59. *Id.*
60. *Id.*
61. *Id.*

D. Additional Related Problems

Among major theoretical impediments to applying such an analysis to the pricing of open-end credit are problems stemming from the multifaceted pricing regimens and underlying purposes typical of such plans. Presumably, it is the overall mix of various charges and fees which contributes to a given plan's appeal to potential customers. A given institution might reasonably wish to price a certain aspect of such a plan well beyond its actual cost in handling such an occurrence in an effort to discourage certain activity (such as an overlimit charge). Such a charge might then be justifiable economically as a means of attempting to control credit risk by discouraging excessive outstandings. While such a goal clearly has real economic value to an institution, quantification of that value could be subjective in the extreme.[62]

Of additional uncertainty is how such an analysis might apply in a market such as the credit card market where price competition as among interest rates does not seem to be functioning very well if at all, yet there seems little hope, given the number of purveyors, of establishing the existence of an oligopoly, as explicitly envisioned in *Perdue*.

CONCLUSION

Relaxation of financial markets generally has lead to greater flexibility for institutions. In turn, this flexibility has made the environment in which institutions operate generally (and predictably) riskier, with institutions facing increased interest rate volatility and increased competition from new and often aggressive competitors, as well as from institutions venturing into previously forbidden or unavailable markets.[63]

To the extent that institutions, like consumers, are risk averse, this trend has, in many instances, lead to the incorporation of features in financial products that shift risk away from institutions. And, if such features have the "effect" of shifting

62. Similarly, the *Best* court specifically held that a more reasonable characterization of the level of the involved NSF charge was as a disincentive against the practice of writing NSF checks rather than as a penalty for breach of contract. 714 P.2d at 1051.

63. *See generally*, Brown, *Defining, Delineating and Debunking Deregulation*, Proceedings of the American Council on Consumer Interests Annual Conference 1987, available from ACCI, Univ. of Missouri-Columbia.

risk to consumers, for example, through variable price or term characteristics, courts will apparently be increasingly willing to develop and apply more subjective doctrines like unconscionability and good faith by which to measure and potentially control the actions of those financial institutions.

Doctrines appear to be evolving that impose duties on financial institutions to take some care to relate the prices charged for their services to the costs involved in delivering those services. In light of these evolutions and in light of the surprising political vigor of more traditional limits like rate ceilings, it may well be premature to bid farewell to the era of price controls on at least some consumer financial services.